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IN THE

Supreme Court of the United States

October Term, 1982

MARTIN E. HECHT and INVENTEL CORPORATION,

Petitioners,

against

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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PETITIONERS' REPLY BRIEF

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PETITIONERS' REPLY BRIEF

This Reply Brief is submitted in response to the Brief for Respondent in Opposition and in further support of the petition for *certiorari*.

A. Respondent's Attempt to Reconcile *Williamson* and Its Predecessors with this Case

Respondent attempts to paper over the sharp and irreconcilable conflict between the Fifth Circuit in *Williamson* v. *Tucker*, 645 F.2d 404 (5th Cir.) *cert. denied* 102 S.Ct. 396 (1981) and the Second Circuit in the case at bar by observing that both courts sought out the "economic reality."

(Respondent's Brief, p. 11). Respondent's "analysis" of *Williamson* and the case at bar ignores, however, the very real and determinative difference between the approach of the two circuits.

Simply put, *Williamson*—and the Eighth and Tenth Circuit cases on which it relies—seeks to determine whether the purchasers had a non-illusory *right* to exercise control over their investment, even though *all* of the purchasers actually delegated *all* of their responsibilities back to the seller.

By contrast, at bar, the Second Circuit announced that the test for determining the "economic reality" was whether it was "reasonable to expect" the licensees actually to exercise control. (Court of Appeals Opinion, p. 18a).

The Second Circuit Court of Appeals in this case—with more candor than respondent has displayed—freely admitted that it could not distinguish *Williamson*. As the Second Circuit observed (17a-18a):

> "Defendants' other major argument relies heavily upon the Fifth Circuit's dicta in *Williamson, supra*, 645 F.2d at 421:
>
> > 'In each case the actual control exercised by the purchaser is irrelevant. So long as the investor has the right to control the asset he has purchased, he is not dependent on the promoter or on a third party for "those essential managerial efforts which affect the failure or success of the enterprise." '
>
> "See also *id.* at 423-25 (discussing circumstances in which sufficient dependence might nevertheless exist). We do not consider this, standing alone, to be an accurate statement of the law."

The Second Circuit, having dismissed *Williamson*, then went on to announce its own rule, a rule so new that it could not even cite any Second Circuit precedent to support it:

> "This is not to suggest that if it was *reasonable to expect* investors to exercise their retained rights under the sales agency agreement in a nontrivial manner the scheme would still be an investment contract. However, in the case of the Aqua-Sonic offering, this simply was not the case. All of the preceding analysis indicating that licensees *would have been expected* to take the sales agency option equally suggests that they *would not be likely* to terminate the option and take over distribution for themselves shortly thereafter." (Emphasis supplied)

And at p. 19a:

> "If, by contrast [to the facts at bar], the reasonable expectation was one of significant investor control, a reasonable purchaser could be expected to make his own investigation of the new business he planned to undertake and the protection of the 1933 and 1934 Acts would be unnecessary."

No other circuit—and indeed, until this case, not even the Second Circuit—has ever utilized the test of what it was reasonable for the promoters to expect.

Respondent also seeks to distinguish the other cases cited by the petitioners (*Schultz* v. *Dain Corp.*, 568 F.2d 612 [8th Cir. 1978]; *Fargo Partners* v. *Dain Corp.*, 540 F.2d 912 [8th Cir. 1976]; *Mr. Steak, Inc.* v. *River City Steak, Inc.*, 460 F.2d 666 [10th Cir. 1972]) from the facts at bar. But respondent does not and cannot square the reasoning of these cases with the Second Circuit's "reasonable to expect" rule enunciated in this case. In each of those cases,

it was the right to control, and not the exercise of control which was determined here. Neither the Fifth Circuit (in *Williamson*), nor the Eighth Circuit (in *Schultz* and *Fargo*), nor the Tenth Circuit (in *Mr. Steak, Inc.*), nor indeed, even the Eleventh Circuit in its 1982 decision (*Gordon* v. *Terry*, 684 F.2d 736), in any way, relied upon any prediction as to what the promoter might "reasonably expect" purchasers to do. Indeed, it is likely that in each of those cases, had the Second Circuit test been applied, the result would have been different, since in each case it is undisputed that no investor ever exercised any control whatsoever over his investment.

B. Respondent Attempts to Avoid the Conflict in Circuits by Invocation of Allegedly "Dispositive" Findings of Fact

The respondent would have this Court deny *certiorari* because it alleges the District Court made findings of fact which would require the same result under the *Williamson* test as under the novel and conflicting Second Circuit test. The respondent is wrong.

For example, respondent claims that the finding by the District Court, that efforts of others would be undeniably significant to an expectation of profits (District Court Opinion, 47a; Respondent's Brief, p. 5) is dispositive. Under *Williamson*, however, this finding of fact would not be dispositive, particularly since the District Court also found that, with respect to the *sale* of Aqua-Sonic products—*i.e.*, the exercise of those rights specifically granted by the licenses which are claimed to be securities at bar—"there was insufficient evidence upon which it could be found, as opposed to surmised, that the licensees were not capable

of vigorously promoting the sale of Steri products as they had warranted to do." (District Court Opinion, 45a).

As noted above, under the test of *Williamson* and predecessors, the actual significance of the contributions of others is irrelevant so long as the purchaser retains the non-illusory right to control his investments. Significantly, the District Court at bar did not make any finding that the right to control was illusory.

Next, the respondent relies on findings by the District Court that the Aqua-Sonic licensees lacked control over the "combined enterprise" consisting of the *development, manufacture* and sale of the Aqua-Sonic product. The District Court observed that since the licensees had no control over the *manufacturing* process, they lacked control over the "enterprise". (See Respondent's Brief, p. 6).

The District Court's finding that persons who purchased licenses to *sell* Aqua-Sonic products were unable to control the *manufacture* of those products is completely irrelevant to the issue of whether the licensees had the power to control the only asset which they purchased, *i.e.*, the license to sell. Surely, neither the District Court nor the Second Circuit Court would contend that any individual, *e.g.*, an automobile franchisee, licensed to *sell* a product is dependent on the efforts of others within the meaning of the federal securities laws simply because he does not *manufacture* the product and has no control over the manufacturing process. Significantly, in affirming, the Court of Appeals expressly disclaimed any reliance on the District Court's findings of fact with respect to manufacturing the product. (See Court of Appeals Opinion, 10a, fn. 8).

Conclusion

The Supreme Court should grant the petition for a writ of *certiorari*.

Respectfully submitted,

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